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Backgrounder

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The Unnatural NAIRU

by

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The "natural" unemployment rate corresponds to what economists used to call "full employment." The concept has a role to play in economics textbooks, but as a guide to the conduct of monetary policy, it is a menace. It is attracting far too much attention for comfort these days.

There is well-publicized disagreement about the value of the "natural" unemployment rate. CIBC Wood Gundy's number is 7 percent. Bureaucrats in the federal Department of Finance put it at 7.8 percent, but think it likely to fall a little in the near future; Finance Minister Paul Martin has let it be known that he thinks his bureaucrats are unduly pessimistic, but he isn't offering a number of his own. At the other extreme, the Bank of Canada is suspected of harboring an estimate of 8 percent or even higher.

Disagree as they might about its value, many analysts seem to think that the natural rate is also a non-accelerating inflation rate of unemployment, or NAIRU. They believe that the inflation rate increases when, and only when, unemployment falls below its natural level, and that renewed monetary restraint is justified only when the emergence of rising inflation signals that the natural unemployment rate has been reached. If the Bank of Canada acts on these mistaken notions, the boom that is currently gathering steam will soon get out of hand and end, not in a slowdown, but in a bust. Since one consequence of that would be the disappearance of Canada's much-heralded fiscal dividend, there is a lot at stake here.

Neither Natural nor NAIRU

The "natural" unemployment rate is badly named. It is not like one of the "natural constants" one meets in physics, and it is next to impossible to estimate with any precision. At any time, its value depends on, among other things, the demographic structure of the labor force, the mix of skills the labor force provides relative to employers' demands, the rate at which these characteristics are changing, and the effects the social safety net has on the length of time workers devote to searching for jobs on entering the labor force or after being laid off.

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All of these factors change over time, and many of them can be affected by public policy. The recent overhaul of the employment insurance system has put downward pressure on the natural unemployment rate, while public sector downsizing has simultaneously been pushing it up. What the net effects have been and for how long they will be felt is, however, unknown, pending the generation of some hard evidence. Small wonder that people disagree about what Canada's natural unemployment rate is at the moment.

Furthermore, the natural rate is only a NAIRU under very special circumstances. Inflation expectations can be volatile and can affect actual inflation quite independently of unemployment. The manner in which the labor market behaves today also depends in part on the shocks it has been subjected to in the past — to use economists' jargon, it is subject to "hysteresis." Other things being equal, the natural unemployment rate is indeed also the NAIRU. But the real world does not always hold other things equal, so one must apply the lessons of economics textbook exercises to actual policymaking with great care.

Expectations and Hysteresis

With a rapidly improving fiscal situation and a central bank whose anti-inflation credentials are firmly established, expectations of low inflation are well entrenched in Canada for the moment, so the prospect of imminent trouble on this front is remote. Hysteresis, however, is more immediately relevant.

When a labor market has been as slack for as long as Canada's, certain effects linger and leave it less flexible and efficient. For example, the skills of unemployed workers deteriorate for lack of use and their contacts in the labor market erode. Those who were unfortunate enough to enter the labor market when it was slack and who failed to find the all-important first job grew a little older during the recession and became less employable too.

The evidence for Canada is that a period of high unemployment does have effects on the subsequent behavior of the labor market, and by that route on the inflation rate. Though these effects are temporary, they last long enough to be important. Specifically, the market inefficiencies they leave behind ensure that, as recovery from recession proceeds, inflation responds to more than just the size of the gap between actual output and what would be feasible when unemployment is at its natural rate — it is also likely to respond to the speed with which that gap changes. The faster the pace of recovery, the more likely that the bottlenecks the recession left behind will cause inflation to increase even before the natural rate of unemployment is attained.

Implications for Current Policy

If we knew the current value of the natural unemployment rate, these complications would not matter for policy. We would be able to distinguish between a short-term bout of higher inflation brought about by expanding too quickly in the face of temporary bottlenecks and an incipient long-term acceleration brought on by trying to run the economy at too high a level of capacity. But our ignorance here is the main reason we gear monetary policy to achieving medium-term targets for the inflation rate, rather than aiming it directly at the traditional Keynesian goal of "full employment."

The central policy lesson of the rising inflation of the 1970s is that it was utterly foolish to aim monetary policy at a target for unemployment without knowing whether it could be achieved. In the absence of a firm estimate of its natural rate, we could not — and we still cannot. How the unemployment rate has once again managed to be at the center of the debate about a monetary policy regime that was supposed to de-emphasize it is almost beyond comprehension. But it has, and that is dangerous.

If the Bank of Canada took the advice of critics who believe that the natural unemployment rate is in the 7 percent range, it would

maintain an easy monetray policy until inflation began to rise. But it takes about 18 months for the inflationary consequences of monetary policy to materialize, and the Bank would risk allowing the current expansion to gather so much momentum that a severe monetary tightening would be needed to bring things under control. If, on the other hand, the Bank tried to fine tune the unemployment rate so that it did not fall below the Bank's own estimate of the natural rate, and if that estimate were pessimistic, then the Bank would risk bringing the expansion to a premature end — also a rather dismal scenario.

It is high time both the Bank of Canada and its critics started to pay less attention to the unemployment rate and more to the behavior of the money supply. In particular, for the past decade or so, the narrow M1 measure has been a reliable leading indicator of real output growth and, with a longer lag, of inflation. According to this indicator, monetary policy has been extremely expansionary since late 1996. The annual rate of growth of M1 has been in the 15 to 20 percent range for almost a year and shows little sign of slowing.

The fact is that the behavior of inflation over the next 18 months will be the consequence of policy measures that have already been taken and cannot be corrected. That behavior, furthermore, as I have already stressed, will tell us nothing useful about the value of the natural unemployment rate. The Bank of Canada should therefore resist any temptation to calibrate monetary policy to its own or anyone else's estimate of the natural unemployment rate. Its aim for the next year or so should be to reduce money growth to a pace compatible with inflation targets in the 1–3 percent range — say, 5 percent per annum for M1. Seen in this context, the recent increase in short-term interest rates was a welcome step in the right direction. Whether it was enough remains to be seen, but if continued vigorous money growth signals that a little more restraint is needed, the Bank should not hesitate.

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